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No. 79-66

In the Supreme Court of the United States

OCTOBER TERM, 1979

PETER E. AARON, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-29a) is reported at 605 F.2d 612.[1] The opinion of the district court (Pet. App. 30a-50a) is unreported.

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[1] The opinion of the court of appeals, as officially reported, contains a number of substantive corrections that do not appear in the opinion attached to the petition for a writ of certiorari.

JURISDICTION

The judgment of the court of appeals was entered on March 12, 1979. On June 11, 1979, Mr. Justice Marshall extended the time in which to file a petition for a writ of certiorari to and including July 10, 1979. The petition for a writ of certiorari was filed on July 10, 1979, and was granted on October 15, 1979. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the Securities and Exchange Commission must prove scienter in an enforcement proceeding brought under Section 20(b) of the Securities Act of 1933, 15 U.S.C. 77t(b), to enjoin acts and practices in violation of Section 17(a) of the Act, 15 U.S.C. 77q(a).

2. Whether the Securities and Exchange Commission must prove scienter in an enforcement proceeding brought under Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(d), to enjoin acts and practices in violation of Section 10(b) of the Act, 15 U.S.C. 78j(b), and Commission Rule 10b-5, 17 C.F.R. 240.10b-5.

STATUTES AND RULE INVOLVED

1. Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

2. Section 20(b) of the Securities Act of 1933, 15 U.S.C. 77t(b), provides in pertinent part:

> Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion bring an action in any district court of the United States or United States court of any Territory, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond * * *.

3. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. 78j, provides in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

4. Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(d), provides in pertinent part:

Wherever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provisions of this chapter, [or] the rules or regulations thereunder, * * * it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

5. SEC Rule 10b-5, 17 C.F.R. 240.10b-5, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

STATEMENT

1. In February 1976, the Securities and Exchange Commission filed a complaint in the United States District Court for the Southern District of New York against eight defendants, including petitioner,[2] alleging violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange

[2] Each defendant except petitioner consented to the entry of a permanent injunction (Pet. App. 31a).

Act of 1934, 15 U.S.C. 78j(b), and SEC Rule 10b-5, 17 C.F.R. 240.10b-5, in connection with the offer and sale of common stock of Lawn-A-Mat Chemical & Equipment Corp. ("Lawn-A-Mat") (A. 15a-19a).[3] The complaint alleged that petitioner violated and aided and abetted violations of the antifraud provisions because he knew or should have known that certain employees of a broker-dealer firm who were under his supervision were making materially false and misleading representations in the offer and sale of Lawn-A-Mat stock, but failed to take steps to terminate the fraudulent practices (*id.* at 16a-18a).

During the period in question, petitioner was employed by E. L. Aaron & Co., Inc., a registered broker-dealer firm with its principal office in New York City. Petitioner had been employed by the firm for 15 years and served in a managerial and supervisory capacity (Pet. App. 33a). Petitioner maintained the due diligence files for securities in which the firm

[3] The complaint also charged petitioner and three other defendants with violations of the registration provisions of Section 5(a) and (c) of the Securities Act of 1933, 15 U.S.C. 77e(a) and (c) (A. 13a-15a). The district court found that petitioner had violated the registration provisions and enjoined him from future violations (Pet. App. 40a-44a). The court of appeals affirmed this disposition, noting that petitioner had arranged a sham transaction in order to create the appearance of an exemption from the registration requirements of the Act (*id.* at 10a-13a, 21a). Petitioner has not questioned the judgment of the district court insofar as it enjoins him from future violations of the registration provisions.

made a market.[4] He also supervised the firm's employees, received and answered complaints about their activities, and participated in the process of hiring them. As a supervisor of the firm's registered representatives, petitioner conducted sales meetings and discussed sales techniques. He also monitored the trading activities of the registered representatives, advising them of their monthly transaction figures and informing them when clients were late in making payment (*ibid.*).

In November 1974, Aaron & Co. opened a branch office in Roslyn Heights, New York. Norman Schreiber, a registered representative of Aaron & Co., was appointed branch manager of the new office. Donald Jacobson, another registered representative, served as Schreiber's assistant. From November 1974 through September 1975, Schreiber and Jacobson contacted stockholders of Lawn-A-Mat and its franchise-dealers by telephone and by mail to solicit orders for Lawn-A-Mat common stock. In the course of this promotion, they repeatedly made false and misleading statements to prospective investors. Among other material misrepresentations, they stated that Lawn-A-Mat was planning or was in the process of manufacturing a new type of small car and tractor. They also told investors that the car would be marketed in six weeks. In fact, Lawn-A-Mat had no plans to manufacture a car or tractor (Pet. App. 35a).

[4] Those files contained current information on the business activities and financial condition of various issuer companies, including Lawn-A-Mat (Tr. 315-316, 322, 329-330).

Schreiber and Jacobson also made projections of substantial increases in the price of Lawn-A-Mat stock and in the sales and earnings of the company. In fact, the company was experiencing losses during the period in question and Schreiber and Jacobson had no basis for making optimistic financial predictions (*ibid.*).

Some of the prospective investors contacted by Schreiber and Jacobson complained to Lawn-A-Mat about these statements. As a result, Fernando Erazo, a Lawn-A-Mat officer, and Milton Kean, an attorney representing Lawn-A-Mat, informed Schreiber and Jacobson that their statements were false and asked them to cease making the false statements. Nonetheless, Jacobson and Schreiber continued to make such assertions while soliciting securities orders (Pet. App. 34a-36a).

When the warnings given to Schreiber and Jacobson proved to be ineffective, Kean complained to petitioner on two occasions, warning him that Schreiber and Jacobson were continuing to make false and misleading statements in connection with their selling campaign (Pet. App. 35a-36a). The due diligence files in petitioner's custody at the time also confirmed that there was no factual basis for the representations that Schreiber and Jacobson were making to prospective investors (*id.* at 36a, 38a). Petitioner mentioned Kean's complaint to Jacobson, but, notwithstanding his supervisory responsibilities under the federal securities laws (see page 43, *infra*) and his assurance to Kean that he would stop the misrepresentations,

petitioner permitted Schreiber and Jacobson to continue their fraudulent behavior (Pet. App. 38a-39a).

2. Following a three-day trial, the district court concluded that petitioner violated Section 17(a), Section 10(b), and Rule 10b-5 by failing to take steps to terminate the fraudulent practices of Jacobson and Schreiber after those practices had been brought to his attention (Pet. App. 39a-40a). The district court found that petitioner "was specifically responsible for supervising the registered representatives" of his firm (Pet. App. 39a; *id.* at 32a-33a)[5] and that petitioner therefore "must be held responsible along with Schreiber and Jacobson for the fraudulent representations that were made" (*ibid.*). Accordingly, the court enjoined him from future violations of Section 17(a), Section 10(b), and Rule 10b-5 (Pet. App. 31a, 45a).

The court of appeals affirmed (Pet. App. 21a). Addressing Section 10(b) and Rule 10b-5, the court rejected petitioner's contention that the Commission must establish scienter to obtain an injunction against future violations of these provisions. The court held that deceptive practices resulting from a defendant's negligence are a sufficient predicate for injunctive relief authorized by Section 21(d) of the Securities Exchange Act. The court of appeals noted that this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 194 n.12 (1976), which held that scienter is a necessary element of a private damage action

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[5] Petitioner does not challenge this finding.

under Section 10(b) and Rule 10b-5, had "explicitly left open the question whether scienter would be required in * * * injunction actions" (Pet. App. 13a). In declining to adopt a scienter requirement for Commission injunctive proceedings, the court of appeals analyzed the language of Section 10(b), the legislative history of the Securities Exchange Act, the relationship between Section 10(b) and the express private remedy provisions of the securities laws, the effect that a scienter standard would have on the enforcement scheme fashioned by Congress, and the "compelling distinctions between private damage actions and government injunction actions" (Pet. App. 15a, 17a-18a). The court observed that its prior decisions had required scienter in private damage actions even before *Hochfelder*, but uniformly had held "that the language and history of [Section 10(b)] did not require a showing of scienter in an injunction enforcement action brought by the Commission" (*id.* at 15a). Quoting its decision in *SEC* v. *Coven*, 581 F.2d 1020, 1027-1028 (2d Cir. 1978), cert. denied, 440 U.S. 950 (1979), the court remarked that "[t]he essential nature of an SEC enforcement action is equitable and prophylactic; its primary purpose is to protect the public against harm, not to punish the offender" (Pet. App. 16a). The court also explained that a negligence standard in injunctive proceedings is consistent with the statutory enforcement scheme because, unlike the situation in *Hochfelder*, no provisions of the federal securities laws would be nullified or superseded by permitting the Commission to

obtain injunctions based on proof of negligent deceptive practices (*id.* at 18a-19a).[6]

The court of appeals also rejected a scienter requirement for Commission injunctive proceedings brought under Section 17(a), relying on its prior decision in *SEC* v. *Coven*, *supra* (Pet. App. 19a). In *Coven*, the court of appeals had observed that Section 17(a) does not contain language requiring proof of scienter. The *Coven* opinion also explained that the legislative history of Section 17(a) shows that Congress had considered a scienter requirement but "opted for liability without willfulness, intent to defraud, or the like, in enacting § 17(a)." 581 F.2d at 1027-1028.[7]

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[6] In *Hochfelder*, this Court pointed out that the statutory provisions expressly allowing private recovery for negligent conduct, Sections 11, 12(2), and 15 of the Securities Act of 1933, 15 U.S.C. 77k, 77*l*(2), and 77*o*, are "subject to significant procedural restrictions not applicable under § 10(b)." 425 U.S. at 208-209. An extension of private damage remedies under Section 10(b) to cases of negligent wrongdoing, the Court concluded, would "nullify the effectiveness of the carefully drawn procedural restrictions on these express actions." 425 U.S. at 210.

[7] Because it found proof of scienter to be unnecessary in this proceeding, the court of appeals declined to "reach the question whether [petitioner's] conduct would support a finding of scienter * * *" (Pet. App. 13a). The district court had found that petitioner's misconduct was "sufficient to establish his scienter" and noted that petitioner's conduct would violate the antifraud provisions "under either a negligence or a scienter theory of liability" (*id.* at 40a).

SUMMARY OF ARGUMENT

I.

In determining Congress' intent in enacting antifraud provisions forbidding deception in securities transactions and in conferring authority on the Commission to seek injunctive relief against violations of those provisions, it is appropriate to consider the historical approach of courts of equity to fraudulent practices. In authorizing equitable relief against fraudulent practices under Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act, Congress did not legislate on a blank slate. At the time that Congress enacted the federal securities laws it was well established that, while intent to deceive was generally required to secure money damages for fraud in an action at law, relief against fraud could be had in equity without proof of scienter. As this Court noted in *Smith* v. *Richards*, 38 U.S. (13 Pet.) 26, 36 (1839): "[i]f * * * a man * * * make a false representation, whether knowingly or not, by means of which he puts the party bargaining under a mistake upon the terms of bargain, it is a fraud, and relievable in equity."

Prior to the federal securities laws, various states enacted securities statutes providing governmental authority to seek injunctions against securities fraud. For example, under New York's Martin Act (N.Y. Gen. Bus. Law §§ 352-353 (Consol. 1921)), which served as a model for Section 17(a) of the Securities Act and for the scheme of injunctive remedies pro-

vided under the Securities Exchange Act, it was well established that the New York Attorney General could obtain an injunction against fraud without proof of scienter.

This tradition of broad equitable jurisdiction over deceptive practices underlies the Court's decision in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), the decision cited by this Court in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 194 n.12 (1976), in reserving judgment on the question whether scienter must be proven in injunctive proceedings brought under Section 10(b) of the Securities Exchange Act. *Capital Gains*, which provides the rule of statutory interpretation that is controlling in the present case, was a suit by the Commission for injunctive relief to restrain deceptive practices forbidden by the general antifraud provision of the Investment Advisers Act. This Court concluded that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." 375 U.S. at 193. The Court pointed out that intention to defraud or misrepresent is not a necessary element of fraud in equity and added that it should not be assumed that Congress, in enacting the federal securities laws, was unaware of this doctrine or meant to depart from it. *Id.* at 192-195.

The similarities between the present case and *Capital Gains* are apparent. Both involve remedial statutes granting broad equitable jurisdiction to the district courts to issue injunctions, and both involve

general antifraud provisions intended to protect investors against deception. Moreover, both cases involve statutes enacted at a time when the distinction between fraud at law and in equity was well established both in general jurisprudence and in the field of securities regulation. These similarities support the conclusion of the court of appeals that injunctive relief, in contrast to the legal remedy of money damages, may be had without proof of scienter or fraudulent intent.

II.

The language of Section 17(a)(2) and (3) of the Securities Act, 15 U.S.C. 77q(a)(2) and (3), confirms that scienter is not an element in an injunctive proceeding brought by the Commission under those provisions. Section 17(a)(2) forbids any person to obtain money or property in the offer or sale of a security "by means of any untrue statement of a material fact or any omission to state a material fact." Section 17(a)(3) forbids any person to engage in "any transaction, practice, or course of business which operates or would operate as a fraud or deceit" in the offer or sale of a security. Although petitioner argues that a scienter requirement should be read into these terms, "[n]othing on the face of the statute supports this reading of it." *United States* v. *Naftalin*, No. 78-561 (May 21, 1979), slip op. 5. To the contrary, this Court's holding in *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, and the views expressed in *Ernst & Ernst* v. *Hochfelder*, *supra*, confirm that the language used by Congress in Section

17(a)(3) does not require proof of an intent to deceive. Moreover, as the Court noted in *Hochfelder* with respect to the virtually identical language appearing in Rule 10b-5(b), Section 17(a)(2) contains an unqualified prohibition against misstatements or omissions used to obtain money from other persons in securities transactions, without any suggestion of a scienter requirement. In sum, engrafting an exception onto these general antifraud provisions to immunize negligent misrepresentations "would create a loophole in the statute that Congress simply did not intend to create." *United States* v. *Naftalin*, *supra*, slip op. 8.

The legislative history confirms that Congress intended to dispense with a scienter requirement in Commission injunctive proceedings brought under Section 17(a). Early drafts of Section 17(a) included the requirement that the forbidden deceptive conduct be undertaken "willfully" and "with the intent to defraud." Those terms, which were inserted to require proof of scienter, were subsequently stricken by the Conference Committee before Section 17(a) was enacted. Under the resulting statutory scheme, "willful" behavior must be proven in a criminal prosecution brought to enforce Section 17(a). See Section 24 of the Securities Act, 15 U.S.C. 77x. But no such requirement is imposed by the statutory provision authorizing injunctive relief in an equitable proceeding brought under Section 17(a). See Section 20(b) of the Act, 15 U.S.C. 77t(b).

III.

The general prohibition of fraudulent practices contained in Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), as implemented by SEC Rule 10b-5, 17 C.F.R. 240.10b-5, extends to any "manipulative or deceptive device or contrivance" used in connection with a securities transaction. Neither this section nor the section of the Act authorizing injunctive relief (Section 21(d), 15 U.S.C. 78u(d)) contains an express scienter requirement. Although this Court held in *Ernst & Ernst* v. *Hochfelder*, *supra*, that Section 10(b) requires proof of scienter in a private action for damages, the Court expressly stated that it was not deciding whether scienter must be proven in the different context of an injunctive proceeding. 425 U.S. at 194 n.12. In limiting its holding in *Hochfelder*, the Court cited *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 193, which concluded that " '[f]raud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element' " in an action for equitable relief.

The court of appeals' conclusion that scienter is not required in an injunctive proceeding brought under Section 10(b) is supported not only by *Capital Gains* but also by the great majority of lower court decisions, handed down both before and after *Hochfelder*. Although *Hochfelder* found that the language of Section 10(b) is "sufficiently clear in its context" to warrant a scienter requirement (425 U.S. at 201), the meaning of the words used by Congress is altogether different in the context of an injunctive proceeding. It was well settled when Congress enacted Section 10(b) that equitable remedies were available in the case of deception without proof of scienter. Here, as in *Capital Gains*, it is not appropriate to "assume that Congress, in enacting legislation to prevent fraudulent practices * * *, was unaware of these developments in the common law of fraud." 375 U.S. at 195.

The Commission has consistently interpreted Section 10(b) to authorize injunctive relief against deceptive practices in securities transactions without proof of scienter. When Congress enacted significant amendments to the Securities Exchange Act in 1975 and 1977, it reviewed the Commission's interpretation and left it undisturbed. As noted in *Andrus* v. *Allard*, No. 78-740 (Nov. 27, 1979), slip op. 6, "it is particularly relevant that Congress has twice reviewed and amended the statute without rejecting the [agency's] view." See also *United States* v. *Rutherford*, No. 78-605 (June 18, 1979), slip op. 8-9 & n.10: "once an agency's statutory construction has been 'fully brought to the attention of the public and the Congress,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned." This consideration provides additional support for the court of appeals' holding that Congress did not intend to require proof of scienter in an injunctive proceeding brought under Section 10(b).

IV.

The structure of the Securities Act of 1933 and the Securities Exchange Act of 1934 reinforces the conclusion that scienter is not required in injunctive proceedings brought under Sections 17(a) and 10(b). The concept of state of mind is treated with precision in the federal securities laws by use of words such as "knowing" and "willful." Thus, if Congress had wished to impose a state of mind requirement in Commission injunctive proceedings under the provisions involved in this case, it would have done so expressly. However, Sections 17(a) and 10(b), and the statutory provisions authorizing injunctive relief, contain no such requirement. These provisions stand in sharp contrast to the criminal penalty and certain administrative sanction provisions of the federal securities laws, which expressly require willfulness.

V.

Finally, it is appropriate to consider the practical consequences of the statutory interpretations advanced by the parties and their consistency with the underlying purposes of the securities laws. Adoption of petitioner's contention would immunize negligent deceptive practices from restraint and would thereby expose investors and the national economy to serious injury resulting from the dissemination of false financial information. Financial information disseminated in the national securities markets is used by individual investors, as well as by institutional investors such as bank trust departments, insurance

companies, and mutual funds, which rely on the accuracy of the information to make investment decisions involving large sums of money. As Judge Friendly observed in *United States* v. *Benjamin*, 328 F.2d 854, 863 (2d Cir.), cert. denied, 377 U.S. 953 (1964), "[i]n our complex society," false financial representations "can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." If, through carelessness, false information is conveyed, and the resulting deception threatens to be recurrent and injurious, the courts should not be powerless to protect the public through the prophylactic remedy of an injunction.

The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted following the stock market crash of 1929. Congress estimated in 1933 that investors had lost as much as 25 billion dollars as a result of false information about the securities that they purchased. The legislative history is replete with references to the grave harm to the nation caused by negligent misrepresentations in securities transactions. The statutes resulting from these concerns, as this Court repeatedly has stated, were intended to achieve a "high standard of business ethics * * * *in every facet of the securities industry.*" *United States* v. *Naftalin, supra*, slip op. 6 (emhasis in original). To deny the courts authority to order the "mild prophylactic" of injunctive relief (*SEC* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. at 193) to protect the public against

negligent dissemination of false information would defeat this important statutory purpose.

The Commission's enforcement program is critical to its ability to protect investors, and injunctions are the basic tools through which the Commission seeks compliance with the federal securities laws. Courts of equity traditionally have gone further to give relief when the public interest, rather than a matter of only private concern, is involved. Consistent with this tradition, federal courts should be permitted to enjoin deceptive conduct without proof of scienter. As the court of appeals correctly observed, "the increased effectiveness of government enforcement actions * * * outweigh[s] the danger of potential harm to those enjoined from violating the securities laws" (Pet. App. 15a).

ARGUMENT

PROOF OF SCIENTER IS NOT REQUIRED IN ENFORCEMENT PROCEEDINGS BROUGHT BY THE SECURITIES AND EXCHANGE COMMISSION TO ENJOIN FUTURE VIOLATIONS OF SECTION 17(a) OF THE SECURITIES ACT OF 1933 OR SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND COMMISSION RULE 10b-5

The question presented in this case is whether, in an enforcement action brought by the Securities and Exchange Commission, a federal district court, having found that a defendant has engaged in deceptive conduct in connection with a securities transaction and, unless enjoined, is likely to continue to engage in such conduct, may grant injunctive relief without proof that the defendant engaged in the deceptive

conduct with scienter. Resolution of this question—whether lack of due care, as well as scienter, may serve as a predicate for injunctive relief—will determine in no small degree the Commission's ability to protect the public from deceptive acts and practices. The two substantive statutory provisions here at issue, Sections 17(a) and 10(b), are the principal antifraud provisions of the Securities Act and the Securities Exchange Act, and Commission injunctive actions are the basic means through which these provisions are enforced. A technical and restrictive interpretation of these provisions, requiring proof of scienter and thus limiting the availability of injunctive relief when it is likely that deception will continue, would significantly weaken the important safeguards against fraud provided to public investors through Commission injunctive actions.

We contend that Congress authorized the district courts to grant the equitable remedy of an injunction in Commission actions without a showing of scienter. Petitioner disagrees, arguing that this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), requires proof of scienter in injunctive proceedings as well as private damage actions. Yet *Hochfelder* expressly declined to address the question "whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5," citing *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). 425 U.S. at 194 n. 12. Moreover, *Hochfelder* did not consider the requirements

of Section 17(a) of the Securities Act of 1933, an independent basis for liability in the present case.

Hochfelder establishes, with respect to Section 10(b) and Rule 10b-5, that scienter must be proven in a judicially-implied private action for damages.[8] In the present case, the issue is whether scienter must be proven in an expressly authorized enforcement proceeding brought by the Securities and Exchange Commission to obtain injunctive relief, a remedy that is wholly equitable in nature. In this different context, the controlling precedent is *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, not *Hochfelder*. In *Capital Gains*, this Court concluded, in construing a parallel antifraud provision of the federal securities laws, that " '[f]raud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element.' " 375 U.S. at 193.

In the discussion below, we review the fundamental distinction between equitable proceedings brought to restrain fraudulent practices and private actions brought to obtain monetary relief. Against this background, we consider the meaning of the words used by Congress in Sections 17(a) and 10(b) and the teaching of the legislative history. We also consider the structure of the Securities Act of 1933 and the Securities Exchange Act of 1934, contrasting

[8] In this brief, "scienter" refers to intent to deceive or defraud, including knowing conduct and reckless disregard for the truth—conduct more culpable than negligence. See *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 194 n.12.

the language of Sections 17(a) and 10(b) and the statutory provisions authorizing injunctive relief with the language Congress repeatedly used to prescribe state of mind standards. Finally, we consider the practical consequences of a scienter requirement for Commission injunctive actions, in light of the purposes that Congress sought to achieve by this legislation. These considerations support the conclusion that, in the present circumstances as in *Capital Gains*, the Commission may enforce the securities laws to protect the public against deceptive practices in securities transactions without proof of intent to defraud.

I. Proof Of Scienter Historically Has Not Been Required To Obtain Equitable Relief Against Fraudulent Practices

In Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934, Congress enacted antifraud provisions to protect the public against misrepresentations and other deceptive practices in securities transactions; Congress authorized injunctive relief against such practices in Commission enforcement proceedings brought under Section 20(b) of the Securities Act, 15 U.S.C. 77t(b), and Section 21(d) of the Securities Exchange Act, 15 U.S.C. 78u(d). In construing these provisions, it is necessary to "begin with the language of the statute itself." *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, No. 77-1645 (Nov. 13, 1979), slip op. 4; *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 197. But as the Court reminded lower courts and litigants in *St. Paul Fire*

& Marine Ins. Co. v. *Barry*, 438 U.S. 531, 545-546 (1978), "words or phrases in a statute come 'freighted with the meaning imparted to them by the mischief to be remedied and by contemporaneous discussion. In such conditions history is a teacher that is not to be ignored'" (quoting *Duparquet Co.* v. *Evans*, 297 U.S. 216, 221 (1936) (Cardozo, J.)). Accord, *United Steelworkers of America, AFL-CIO-CLC* v. *Weber*, No. 78-432 (June 27, 1979), slip op. 5-6; *Agosto* v. *INS*, 436 U.S. 748, 754 (1978); *Standard Oil Co.* v. *United States*, 221 U.S. 1, 59 (1911).[9]

Placing the words used by Congress in historical perspective permits the reviewing court to ascertain the underlying statutory purpose—"courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350-351 (1943). See also *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 849-851 (1975); *United States* v. *American Trucking Ass'ns*, 310 U.S. 534, 543 (1940).

1. In authorizing equitable relief against fraudulent practices in securities transactions, Congress did not legislate on a blank slate. The law governing

[9] See also *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 744-749 (1975).

equitable remedies against fraudulent practices was well established at the time Congress enacted the federal securities laws.

The requirement of scienter or fraudulent intent was the characteristic requirement in common law actions seeking monetary damages for fraud. The decision of the House of Lords in *Derry* v. *Peek*, 14 App. Cas. 337 (1889), reaffirmed the common law requirement of scienter in the securities fraud context, holding that a private damage action based on negligent misrepresentations would not lie.[10] But *Derry* itself confirmed that the rule in equity was different. *Id.* at 359. As this Court emphasized in *Smith* v. *Richards*, 38 U.S. (13 Pet.) 26, 36 (1839), "[i]f * * * a man, upon a treaty for any contract, make a false representation, whether knowingly or not, by means of which he puts the party bargaining under a mistake upon the terms of bargain, it is a fraud, and relievable in equity."

The rule in equity, providing relief for defrauded plaintiffs without proof of scienter, received general recognition prior to the enactment of the federal securities laws. See, *e.g.*, 1 J. Story, *Commentaries on Equity Jurisprudence* §§ 272, 368 (14th ed. W. Lyon 1918); II J. Pomeroy, *Equity Jurisprudence* § 885 (4th ed. 1918); H. Black, *Rescission of Contracts and Cancellation of Written Instruments* §§ 102, 106, 108 (2d ed. J. Lee 1929); 3 S. Williston, *The Law of Con-*

[10] See also 3 *Restatement of Torts* §§ 525-526 (1938); F. Harper, *The Law of Torts* § 76 (1933); XXVI C.J., *Fraud*, § 6 (1921).

tracts § 1500 (1920); G. Bower, *The Law of Actionable Misrepresentation* § 250 (2d ed. 1927); W. Walsh, *A Treatise on Equity* § 109 (1930); *Restatement of Contracts* § 476 & Comment b. (1931).[11] The fundamental difference between fraud at law and in equity lies in the shift in focus from the *cause* of injury to the *fact* of injury:

> The wrongdoer being the target of courts of law, the "action" through which legal remedies are obtained must be predicated upon fault, the substantive law becomes a system of rights and wrongs, and all its remedies center about redress, vindication, punishment, restitution. In considering the field of preventive justice, the averting or minimizing of injury, the viewpoint shifts radically and with it both the character of the relief and the substantive underlying principles. It is not the *cause* but the *fact* of injury, and the problem of its practical control through judicial action which concern the court.
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> * * * * *
>
> [Equity] is not concerned with the vindication of a right or the condemnation of a wrong, it protects merely from injury.

J. Lawrence, *Substantive Law of Equity Jurisprudence* §§ 13, 17 (1929) (emphasis in original). See

[11] Modern authorities also confirm the fundamental proposition that equity regards misrepresentations as fraudulent without proof of scienter. See, *e.g.*, 1 F. Harper & F. James, *The Law of Torts* 603 (1956); W. Prosser, *The Law of Torts* 687 (4th ed. 1971). See also Note, *The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After Ernst & Ernst* v. *Hochfelder*, 77 Colum. L. Rev. 419, 428 (1977).

also Shulman, *Civil Liabilities Under the Securities Act*, 43 Yale L.J. 227, 231, 233 (1933).

2. Consistent with this tradition of broad equitable relief against fraud, several state legislatures, prior to the passage of the federal securities laws, enacted their own securities laws with antifraud provisions forbidding the use of deception in securities transactions and creating governmental authority to investigate and seek to enjoin securities frauds. See I L. Loss, *Securities Regulation* 33-34, 35-43 (1961); L. Loss and E. Cowett, *Blue Sky Law* 17-26 (1958). Conspicuous among these state statutes was the New York Martin Act, N.Y. Gen. Bus. Law §§ 352-353 (Consol. 1921), under which the State Attorney General commenced numerous injunctive proceedings to restrain securities frauds. See McCall, *Comments on the Martin Act*, 3 Brooklyn L. Rev. 190, 203 (1934) (2,682 individuals and corporations enjoined between 1931 and 1933). The enforcement pattern under the New York statute is of particular significance in the present context because Congress used the Martin Act as one of its principal models in drafting the Securities Act of 1933, and, more particularly, relied on the Martin Act in formulating the prohibitory language of Section 17(a). See *Securities Act: Hearings on S.875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 253 (1933); *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 11, 109 (1933). See also I Loss, *supra*, at 128; III Loss, *supra*, at 1440. The Martin Act was also cited during the congressional debates

in explaining the injunction provisions under the Securities Exchange Act of 1934. See 78 Cong. Rec. 8096 (1934) (remarks of Rep. Black).

The Martin Act empowered the Attorney General to seek an injunction whenever it appeared that any person had engaged in or was about to engage in a fraudulent securities transaction. N.Y. Gen. Bus. Law §§ 352-353 (consol., 1921). In the landmark case of *People* v. *Federated Radio Corp.*, 244 N.Y. 33, 154 N.E. 655 (1926), the New York Court of Appeals held that securities fraud could be enjoined in equity under the state statute without proof of scienter:

> The words "fraud" and "fraudulent practice" * * * should * * * be given a wide meaning, so as to include all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law.
>
> * * * * *
>
> Intentional misstatements, as in an action at law to recover damages for fraud and deceit * * *, need not be alleged. Material misrepresentations intended to influence the bargain, on which an action might be maintained in equity to rescind a consummated transaction, are enough. Promoters are under a duty to make reasonable investigation before issuing a prospectus, and to the extent that they fail in the performance of their duty, lack of scienter will not relieve them from liability in actions brought under the Martin Act.

244 N.Y. at 38-39, 41; 154 N.E. at 657-658.[12] The New York Attorney General's authority to obtain injunctions to restrain securities fraud without proof of intent to deceive or defraud was repeatedly upheld following *Federated Radio*. See *People* v. *Rice*, 221 A. D. 443, 223 N.Y.S. 566 (App. Div. 1927); *People* v. *F.H. Smith Co.*, 136 Misc. 449, 240 N.Y.S. 807 (Sup. Ct.), aff'd in relevant part, 230 A. D. 268, 243 N.Y.S. 446 (App. Div. 1930); *People* v. *Ruocco*, 137 Misc. 400, 242 N.Y.S. 41 (Sup. Ct. 1930); *People* v. *New York City Air Port, Inc.*, 143 Misc. 472, 256 N.Y.S. 89 (Sup. Ct. 1931).[13]

As noted by one commentator summarizing this line of authority shortly before the enactment of the Securities Exchange Act of 1934:

> It is immediately manifest that if the Attorney General were limited in his enforcement of the

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[12] Professor Loss has described *Federated Radio* as "one of the leading cases on the concept of fraud in securities legislation, state or federal." I Loss, *supra*, at 41 n.78.

[13] Contemporary legal commentary on Blue Sky statutes noted that injunctions were available without regard to scienter. See Note, *Liability for Misrepresentations in Corporate Prospectuses*, 40 Yale L.J. 987, 988 (1931). See also Loss and Cowett, *supra*, at 251. The Uniform Sale of Securities Act, approved by the National Conference of Commissioners on Uniform State Laws in 1929, also provided for injunctive relief against deceptive practices. National Conf. of Commissioners on Uniform State Laws, *Handbook and Proceedings* 173-204 (1929). State of mind was an element in the private damage and criminal penalty provisions of the statute (Sections 16 and 17), but not the section authorizing injunctive relief against deceptive practices (Section 15). The Uniform Sale of Securities Act, like New York's Martin Act, was considered by Congress when the Securities Act of 1933 was adopted. See I Loss, *supra*, at 128.

> Act to cases of intentional fraud the result of such interpretation would, in effect, place him in the position of a plaintiff in the common law action of fraud and deceit. It seems equally obvious that such could not have been the purpose of the Legislature, as the nature of the relief provided for in the Act is essentially equitable and designed solely for the protection of the people of the state in general against fraudulent practices in the advertisement or sale of securities.

McCall, *supra*, 3 Brooklyn L. Rev. at 198.

3. These legal principles—that terms describing rights and wrongs may have a different meaning in equity than at law and that scienter is not required when equitable rather than legal relief is sought—underlie this Court's decision in *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*. The issue in *Capital Gains* was "whether Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit upon any client or prospective client,' intended to require the Commission to establish fraud and deceit 'in their technical sense,' including intent to injure and actual injury to clients, or whether Congress intended a broad remedial construction of the [Investment Advisers] Act which would encompass nondisclosure of material facts." 375 U.S. at 185-186. The injunction sought by the Commission in *Capital Gains* was intended to require the defendant investment adviser to disclose secret securities transactions that arguably affected the quality of investment advice rendered to clients.

The Commission contended that failure to disclose such transactions defrauded clients within the prohibition of Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6, which forbids investment advisers to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The district court concluded that the Commission was not entitled to injunctive relief without proof of actual "fraud" or "deceit" in their "technical sense," including intent to defraud. *SEC* v. *Capital Gains Research Bureau, Inc.*, 191 F. Supp. 897, 898-899. This Court disagreed.

The Court began its analysis by considering the background and purpose of the federal securities laws. The Court noted that the securities laws were designed to eliminate abuses in the securities industry "which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. * * * A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." 375 U.S. at 186 (footnotes omitted). The Court added that " '[i]t requires but little appreciation * * * of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry." *Id.* at 186-187, quoting *Silver* v. *New York Stock Exchange*, 373 U.S. 341, 366 (1963).

Considering the remedial purpose of Congress in enacting the federal securities laws and the importance of injunctive relief in protecting investors, the Court remarked (375 U.S. at 192-193; footnotes omitted):

> It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold * * * that Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit," intended to require proof of intent to injure and actual injury to clients.
>
> This conclusion moreover, is not in derogation of the common law of fraud, as the District Court and the majority of the Court of Appeals suggested. To the contrary, it finds support in the process by which the courts have adapted the common law of fraud to the commercial transactions of our society. It is true that at common law intent and injury have been deemed essential elements in a damage suit between parties to an arm's-length transaction. But this is not such an action. This is a suit for a preliminary injunction in which the relief sought is, as the dissenting judges below characterized it, the "mild prophylactic" * * * of requiring a fiduciary to disclose to his clients * * * his dealings in recommended securities just before and after the issuance of his recommendations.
>
> The content of common-law fraud has not remained static as the courts below seem to have assumed. It has varied, for example, with the nature of the relief sought, the relationship between the parties, and the merchandise in issue. It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.

Quoting W. DeFuniak, *Handbook of Modern Equity* 235 (2d ed. 1956), the Court added that "'[f]raud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element.'" 375 U.S. at 193. It further explained that strict common law rules "which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue." *Id.* at 194 (footnote omitted). The Court also stated that it was not prepared to assume that Congress was unaware of these principles when it enacted the federal securities laws (id. at 195; footnote omitted):

> We cannot assume that Congress, in enacting legislation to prevent fraudulent practices by investment advisers, was unaware of these developments in the common law of fraud. Thus, even if we were to agree with the courts below that Congress had intended, in effect, to codify the common law of fraud in the Investment Advisers Act of 1940, it would be logical to conclude that Congress codified the common law "remedially" as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not "technically" as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels.

> The foregoing analysis of the judicial treatment of common-law fraud reinforces our conclusion that Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit" upon a client, did not intend to require proof of intent to injure and actual injury to the client. Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation "enacted for the purpose of avoiding frauds," not technically and restrictively, but flexibly to effectuate its remedial purposes.

See also *id.* at 200-201.

The similarities between the present case and *Capital Gains* are apparent.[14] Both cases involve remedial statutes granting broad equitable jurisdiction to the district courts to issue injunctions. Both involve general antifraud provisions of the federal securities laws that are intended to protect investors against deception in securities transactions. And both involve statutes enacted at a time when the distinction between fraud at law and in equity was well established both in general jurisprudence and in the field of securities regulation. These similarities strongly support the conclusion of the court below that injunctive relief is available under Sections 17(a) and 20(b) of the Securities Act of 1933 and Sections 10(b) and 21(d) of the Securities Exchange Act of 1934 without proof by the Commission of intent to deceive or defraud. In a forward-looking injunctive proceeding intended to prevent future injury, as opposed to a private damage action intended to redress past injury, the paramount concern is to stop deception—which has the same potential to cause financial loss whether it results from negligence or intentional misconduct.

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[14] Petitioner argues, in reliance on *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 471 n.11 (1977), that the Court's references in *Capital Gains* to fraud in the equitable sense should be limited to statutes establishing federal fiduciary standards (Br. 14-15). But *Santa Fe* does not support such an argument. *Santa Fe* held only that a breach of fiduciary duty without some element of deception, misrepresentation or nondisclosure is not actionable under Section 10(b). Here, by contrast, petitioner was charged with participating in deception and misrepresentation; the only question is what standard of culpability applies in an action for equitable relief based on that conduct.

Contrary to the assertion of amicus AICPA (Br. 19-20 n.3), *Capital Gains* is not limited to the proposition that "intent to injure" is irrelevant in an SEC injunctive proceeding. This Court also recognized in *Capital Gains* that "intention to defraud or to misrepresent is not a necessary element." 375 U.S. at 193. See also *id.* at 194, 200.

II. The Language And Legislative History Of Section 17(a) Of The Securities Act Of 1933 Confirm that the Commission Need Not Prove Scienter In An Injunctive Proceeding Brought To Restrain Fraudulent Practices

1. The language and legislative history of Section 17(a)(2) and (3) of the Securities Act of 1933 confirm that Congress did not intend to require proof of scienter as a prerequisite to equitable relief against securities fraud. The language of Section 17(a)(2) and (3) does not even suggest that Congress "intended to require the Commission to establish fraud

and deceit 'in their technical sense.' " *SEC* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. at 185. To the contrary, subparagraphs (2) and (3) of Section 17(a) broadly prohibit any person from obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact" and from engaging in "any transaction, practice, or course of business which operates or would operate as a fraud or deceit" in the offer or sale of any security.

Although petitioner argues (Br. 16-17) that scienter should be required under subparagraph (1) of Section 17(a) because that subparagraph uses the phrase "device, scheme, or artifice to defraud," this argument (whatever its merit) has no bearing on subparagraphs (2) and (3). As this Court has recently held, each subparagraph of Section 17(a) "proscribes a distinct category of misconduct. Each succeeding prohibition is meant to cover additional kinds of illegalities—not to narrow the reach of the prior sections." *United States* v. *Naftalin*, No. 78-561 (May 21, 1979), slip op. 5.[15] Limitations applicable to one subparagraph do not restrict the scope of the others. Thus, while petitioner argues that a scienter requirement should be read into Section 17(a)(2) and (3), "[n]othing on the

[15] As this Court has also noted, "we are obliged to give effect, if possible, to every word Congress used. * * * Canons of construction ordinarily suggest that terms connected by a disjunctive be given separate meanings * * *." *Reiter* v. *Sonotone Corp.*, No. 78-690 (June 11, 1979), slip op. 5.

face of the statute supports this reading of it." *United States* v. *Naftalin, supra*, slip op. 3.

The decisions of this Court construing statutory language equivalent to that used in Section 17(a)(3) confirm that scienter is not required. In *SEC* v. *Capital Gains Research Bureau, Inc., supra*, the Court construed the antifraud provision of the Investment Advisers Act of 1940—a provision that forbids advisors "to engage in any transaction, practice, or course of business which operates as a fraud or deceit * * *." See Section 206(2) of the Act, 15 U.S.C. 80b-6(2). The same language also appears in Section 17(a)(3). This Court held in *Capital Gains* that such language does not require a "showing [of] deliberate dishonesty as a condition precedent to protecting investors." 375 U.S. at 200.[16] Moreover, as the Court pointed out in *Ernst & Ernst* v. *Hochfelder, supra*, 425 U.S. at 212, the virtually identical language appearing in Rule 10b-5(c), 17 C.F.R. 240.10b15(c), "arguably * * * could be read as proscribing * * * any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not." The "clear import of the critical phrase in [subparagraph] (3), 'operates as a fraud,' is to focus attention on the *effect* of potentially misleading conduct on the pub-

[16] It is also noteworthy that the language used by Congress in Section 17(a)(3) is even broader than that used in the antifraud provision considered in *Capital Gains*. Section 17(a)(3) forbids practices that "would operate" as a fraud, as well as conduct that does in fact operate in that manner.

lic, not on the culpability of the person responsible." *SEC* v. *Coven*, 581 F.2d 1020, 1026 (2d Cir. 1978) (emphasis in original), cert. denied, 440 U.S. 950 (1979); *Steadman* v. *SEC*, 603 F.2d 1126, 1131-1133 (5th Cir. 1979).

Similarly, subparagraph (2) of Section 17(a) contains an unqualified prohibition against material misstatements or omissions in a securities transaction that are used to obtain the money of another, as this Court noted with respect to the virtually identical language of Rule 10b-5(b) in *Hochfelder*, 425 U.S. at 212. In the words of Professor Loss, "[t]here is nothing on the face of Clause (2) itself which smacks of *scienter* or intent to defraud." III Loss, *supra*, at 1442.

In sum, the language used by Congress shows that intent to deceive or defraud is not required to establish a violation of Section 17(a)(2) and (3). Engrafting an exception onto these provisions to immunize negligent misrepresentations in Commission injunctive proceedings "would create a loophole in the statute that Congress simply did not intend to create." *United States* v. *Naftalin*, *supra*, slip op. 8.[17]

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[17] The great majority of lower court decisions construing Section 17(a)(2) and (3) have also concluded that scienter need not be proven in a Commission injunctive proceeding and that negligence is a sufficient predicate. This is an additional interpretive aid of substantial importance (*Blue Chip Stamps* v. *Manor Drug Stores*, *supra*, 421 U.S. at 731-732, 749; see also *id.* at 760 (Powell, J., concurring)). See *SEC* v. *Blazon Corp.*, No. 77-1904 (9th Cir. Dec. 14, 1979), slip op. 7-10; *Steadman* v. *SEC*, *supra*, 603 F.2d at 1131-1133; *SEC* v. *American Realty Trust*, 586 F.2d 1001, 1006-1007 (4th Cir. 1978) (Section 17(a)(2) only); *SEC* v. *Coven*, *supra*, 581 F.2d at 1026-1027; *SEC* v. *World Radio Mission, Inc.*, 544 F.2d 535, 540-541 (1st Cir. 1976); *SEC* v. *Van Horn*, 371 F.2d 181, 185-186 (7th Cir. 1966); *SEC* v. *Chatham*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,911 at 95,758 (D. Utah 1979); *SEC* v. *Paro*, 468 F. Supp. 635, 647-649 (N.D.N.Y. 1979); *SEC* v. *Wills*, 472 F. Supp. 1250, 1271 (D.D.C. 1978) (Section 17(a)(3) only); *SEC* v. *Jos. Schlitz Brewing Co.*, 452 F. Supp. 824, 831 (E.D. Wis. 1978); *SEC* v. *Western Geothermal & Power Corp.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,920 at 95,859 (D. Ariz. 1979), appeal pending, No. 79-3422 (9th Cir.); *SEC* v. *Southwest Coal & Energy Co.*, 439 F. Supp. 820, 826-827 (W.D. La. 1977), appeal pending, No. 78-1130 (5th Cir.) (Section 17(a)(2) only); *SEC* v. *Geotek*, 426 F. Supp. 715, 726 (N.D. Cal. 1976), aff'd *sub nom. SEC* v. *Arthur Young & Co.*, 590 F.2d 785 (9th Cir. 1979); *SEC* v. *Shiell*, [1977-1978] Fed. Sec. L. Rep. (CCH) ¶ 96,190 at 92,386 (N.D. Fla. 1977). See also *SEC* v. *Arthur Young & Co.*, *supra*, 590 F.2d at 787 (assuming scienter is not required under Section 17(a)).

Only a few courts have required proof of conduct more culpable than negligence. See *SEC* v. *Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975) (recognizing that "the standards of culpability may be lower in SEC injunctive suits than in private damage actions," but nonetheless requiring proof of "willful" or "reckless" behavior); *SEC* v. *Cenco, Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC* v. *Randell*, [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,362 (E.D. Va. 1978), appeal pending, No. 78-1386 (4th Cir.).

2. The legislative history of Section 17(a) of the Securities Act of 1933 confirms that Congress intended no deviation from the traditional standards of fraud in equity evolved under the Martin Act (see pages 27-30 *supra*). The antifraud provision that became Section 17(a) originally appeared in identical bills introduced in the House and the Senate. H.R.

4314, 73d Cong., 1st Sess. (Mar. 29, 1933); S. 875, 73d Cong., 1st Sess. (Mar. 29, 1933).[18] Borrowing from the language of the Martin Act but inserting the word "willfully," Section 13 of both bills would have made it unlawful for any person (emphasis supplied):

> *willfully* to employ any device, scheme, or artifice to defraud or to obtain money or property by means of any false pretense, representation, or promise, or to engage in any transaction, practice, or course of business * * * which operates or would operate as a fraud upon the purchaser.[19]

Both the House and Senate committees considered adding to Section 13 of the bills the phrase "with the intent to defraud." [20] As reported out of committee, the Senate version of the antifraud provision retained the word "willfully" and added the phrase "with the

[18] During the House hearings, H.R. 5480 was substituted for H.R. 4314.

[19] The Martin Act (N.Y. Gen. Bus. Law § 352 (Consol. 1932)) defined fraudulent practices to include:

> any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise * * * or * * * any practice or transaction or course of business * * * which is fraudulent or in violation of law and which has operated or which would operate as a fraud upon the purchaser * * *.

[20] See *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 146 (1933). The phrase "with the intent to defraud" was also included in an early draft of the Senate Bill. See S. 875, 73d Cong., 1st Sess. § 13 (Mar. 29, 1933) (Confidential Committee Print).

intent to defraud" to the first clause quoted above for the express purpose of requiring "fraudulent intent" as an element. See S. 875, 73d Cong., 1st Sess. (Apr. 27, 1933); S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933).

As reported out of the House Committee, however, the bill eliminated the word "willfully." See H.R. 5480, 73d Cong., 1st Sess. § 16(a) (1933). In addition, the House rejected the proposed addition of the phrase "with the intent to defraud." *Ibid.* In the Conference Committee, the House version of the antifraud provision was adopted instead of the Senate version, and the proposed limitation of the statute to intentional misconduct was thus rejected. H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 12, 27 (1933).

Congress' deliberate elimination of the language of intent from Section 17(a) confirms the purpose that Section 17(a) was intended to serve. Congress contemplated that Section 17(a) would serve a dual function. In the case of criminal prosecutions brought against persons engaged in violations of Section 17(a), Congress provided that the government must establish "willful" behavior. See Section 24 of the Act, 15 U.S.C. 77x.[21] But injunctive relief against violations of Section 17(a), sought under Section

[21] Similarly, as a result of a 1936 amendment to the Securities Exchange Act of 1934 (49 Stat. 1378), "willful" violations of Section 17(a) may also serve as the basis for administrative sanctions. See Section 15(b)(4)(D) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4)(D).

20(b) of the Act, 15 U.S.C. 77t(b), could be obtained without proof of scienter or mens rea. See Douglas and Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 181-182 (1933) (mens rea is required in criminal prosecutions but not injunctive proceedings). See also 77 Cong. Rec. 2919, 2920 (1933) (remarks of Rep. Rayburn).

3. Petitioner appears to concede (Br. 18) that the language and history of Section 17(a) of the Securities Act confirm that Congress did not intend to require proof of scienter under subparagraphs (2) and (3). He argues, however, that if scienter is held to be a requirement under Section 10(b) of the Securities Exchange Act and Rule 10b-5, it should also be required under Section 17(a) pursuant to the doctrine of *in pari materia*.

However, as we demonstrate on pages 44-61, *infra*, Section 10(b) and Rule 10b-5 do not require scienter in the context of Commission injunctive proceedings. Thus, the doctrine of *in pari materia* reinforces the conclusion that scienter should not be required under Section 17(a). In any event, even if Section 10(b) and Rule 10b-5 do require proof of scienter in this context, there would be no warrant for limiting the literal scope of Section 17(a). The doctrine of *in pari materia* cannot restrict plain statutory language. See *Erlenbaugh* v. *United States*, 409 U.S. 239, 243-245 (1972). It cannot be relied on to "introduce an exception" in a statute or to "carve a substantial slice from [its] intended coverage." *Id.* at 245, 247. As the Court noted in *United States* v. *Naftalin*,

supra, slip op. 8 n.8, "subsequent enactments do not serve to restrict the original scope of § 17(a)." [22]

4. Amicus Mid-America Legal Foundation agrees that the language of subparagraphs (2) and (3) of Section 17(a) "might encompass" negligent misconduct, but argues that petitioner cannot be enjoined under these provisions unless he "willfully aided and abetted" the forbidden conduct and that "[i]naction alone will not suffice unless the duty to act is clear" (Amicus Br. 5). Mid-America's arguments were not raised in the petition and are not properly before this Court. In any event, there is no requirement of willfulness in the statutory provisions involved here (see pages 61-65, *infra*), and as a supervisor in a brokerage firm, petitioner's "duty to act [was] clear." [23] As the courts below correctly held, by his inadequate supervision of the firm's salesmen when he knew or should have known of their fraudulent practices, petitioner participated in the fraud that was occurring.[24]

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[22] There is no ground for the assertion that Congress added a scienter requirement in Section 17(a) *sub silentio* when it enacted Section 10(b) in 1934. To the contrary, at the time that Congress was considering the Securities Exchange Act of 1934, it considered and rejected an amendment to Section 17(a) that would have limited that section to conduct that was undertaken "willfully and with intent to deceive." 78 Cong. Rec. 8703 (1934).

[23] See 5A A. Jacobs, *The Impact of Rule 10b-5* § 214.02 at 9-128-132 (1979) (collecting cases). See also Sections 15(b)(4)(E) and 15(b)(6) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4)(E) and 78*o*(b)(6).

[24] See note 23, *supra*. Congress intended to provide injunctive relief against all persons "who have played a material

III. The Language And Legislative History Of Section 10(b) Of The Securities Exchange Act Of 1934 Confirm That The Commission Need Not Prove Scienter In An Injunctive Proceeding Brought To Restrain Fraudulent Practices

Section 10(b) of the Securities Exchange Act of 1934 forbids any person to employ, in connection with the purchase or sale of a security, "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 10b-5, which was promulgated by the Commission in 1942 (Securities Exchange Act Release No. 3230 (May 21, 1942)), tracks the language of Section 17(a) of the Securities Act. The rule was promulgated to close "a loophole in the protections against fraud administered by the Commission" (*ibid.*) by making "applicable to the purchase of securities, the same broad antifraud provisions * * * imposed in Section 17(a) of the Securities Act of 1933, in connection with the sale of securities." *In re Ward La France Truck Corp.*, 13 S.E.C. 373, 381 n.8 (1943). The rule was needed to harmonize the law applicable to deception because Section 17(a) is limited in certain circumstances to fraudulent practices directed toward purchasers of securities while Section 10(b), as implemented by Rule 10b-5, also reaches fraudulent practices directed toward sellers of securities.

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part in the commission of an enjoinable act, contributors as well as principals * *." *SEC* v. *Barraco*, 438 F.2d 97, 99 (10th Cir. 1971).

Relying on this Court's decision in *Ernst & Ernst* v. *Hochfelder*, *supra*, petitioner argues (Br. 12) that the words "manipulative or deceptive device or contrivance" used in Section 10(b) impose a scienter requirement in equitable proceedings as well as private damage actions. Although recognizing that scienter is not required by the express language of either Section 10(b) or the section of the Act authorizing injunctive relief (Section 21(d), 15 U.S.C. 78u (d)), petitioner nonetheless contends (Br. 12) that the requirement is "implicit" in the statute, citing the Fifth Circuit's decision in *SEC* v. *Blatt*, 583 F.2d 1325, 1333 n.21 (1978).

1. *Hochfelder* does not answer the question whether the Commission must prove scienter in this injunctive proceeding under Section 10(b). This Court was careful to explain in *Hochfelder* that it "need not consider the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5. Cf. *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180 (1963)." 425 U.S. at 194 n. 12. If the Court had believed that its reasoning in *Hochfelder* was controlling in this different context, it would not have expressly limited its holding and would not have cited its prior decision in *Capital Gains*, a decision which concluded, as we have noted, that " '[f]raud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element' " (375 U.S. at 193).

The question before the Court in *Hochfelder* was "whether a private cause of action for damages will

lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' * * *." 425 U.S. at 193. In adopting a scienter requirement under Section 10(b) and Rule 10b-5, the Court brought the elements of a judicially implied cause of action for damages into harmony with the elements of private tort actions based on deceit—actions that are in many respects parallel to implied actions under Section 10(b) (*Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 744 (1975)). The present proceeding is not a private damage action. It is a government enforcement proceeding expressly authorized by Congress to secure prophylactic equitable relief. As this Court has recognized repeatedly, the elements that must be proven in such a statutory enforcement proceeding are different from those in private damage suits. See *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*; *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 467 n.9 (1969). See also *United States* v. *Naftalin*, *supra*, slip op. 5 n.6.

Because the Court considered a private damage action in *Hochfelder*, it was necessary to construe the language of Section 10(b) in a manner that would not result in conflicts with the express private remedy provisions for negligent conduct contained in other parts of the federal securities laws. The Court concluded that implication of a private right of action under Section 10(b) for negligent conduct would disrupt the statutory scheme by "nullify[ing] the effectiveness of the carefully drawn procedural re-

strictions on these express actions." 425 U.S. at 210. In contrast, as the court below correctly observed, "there are no comparable provisions which would be nullified by permitting SEC enforcement actions to be predicated on a showing of negligence" (Pet. App. 18a-19a).

Moreover, the policy considerations that supported the Court's holding in *Hochfelder* are not applicable here. *Hochfelder* reiterated the concern, expressed over 40 years earlier by Judge Cardozo in *Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), that a private damage remedy based solely on negligence could subject defendants to "liability in an indeterminate amount for an indeterminate time to an indeterminate class." 425 U.S. at 215-216 n.33. Those concerns do not arise in an enforcement proceeding seeking to restrain future misrepresentations. This form of preventive remedy protects the public without imposing draconian liability on persons who have negligently deceived others. The New York courts recognized this distinction, affording equitable relief in the absence of scienter. See *Ultramares Corp.* v. *Touche*, *supra*, 174 N.E. at 447; see also cases cited at pages 28-29, *supra*.

In light of the fundamental differences between this case and *Hochfelder*, the court of appeals correctly concluded that *Hochfelder* is not controlling here; in an injunctive action under Section 10(b), as under Section 17(a), the Court's prior decision in *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, affords appropriate guidance. See Note, *The Scienter Requirement in SEC Injunctive En-*

forcement of Section 10(b) After Ernest & Ernst v. *Hochfelder*, 77 Colum. L. Rev. 419 (1977). That conclusion is buttressed by the decisions of the majority of the courts of appeals that have considered the question, which have concluded, both before and after *Hochfelder*, that the Commission need not prove scienter in an equitable enforcement proceeding brought under Section 10(b). See, *e.g.*, *SEC* v. *World Radio Mission, Inc.*, 544 F.2d 535, 541 n.10 (1st Cir. 1976); *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 809 (2d Cir. 1975); *SEC* v. *Dolnick*, 501 F.2d 1279, 1284 (7th Cir. 1974); *SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1095-1097 (2d Cir. 1972); *SEC* v. *Geyser Minerals Corp.*, 452 F.2d 876, 880-881 (10th Cir. 1971); *SEC* v. *Pearson*, 426 F.2d 1339, 1343 (10th Cir. 1970); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 863 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). The only court of appeals decision to the contrary is *SEC* v. *Blatt*, *supra*, which concluded that the scienter standard adopted in *Hochfelder* is applicable both in private damage actions and in Commission injunctive suits.[25]

Judge Friendly's concurring opinion in *SEC* v. *Texas Gulf Sulphur Co.*, *supra*, anticipating this Court's decision in *Hochfelder*, concluded that imposition of private damage liability under Section 10(b) and Rule 10b-5 based on mere negligence is improper (401 F.2d at 866-868). With respect to injunctive relief, however, Judge Friendly concluded, citing this Court's decision in *Capital Gains*, that proof of scienter is not essential. *Id.* at 868.

[25] Cf. also *SEC* v. *Coffey*, *supra*, 493 F.2d at 1314, discussed at note 17, *supra*.

2. We of course recognize that the Court in *Hochfelder* concluded that the language of Section 10(b) is "sufficiently clear *in its context*" to warrant imposition of a scienter standard. 425 U.S. at 201 (emphasis supplied). We submit, however, that the meaning of the words used by Congress is altogether different in the "context" of an injunctive proceeding. As the discussion on pages 24-35, *supra*, shows, it was well settled when Section 10(b) was enacted that equitable remedies were available in the case of deception without proof of scienter. Here, as in *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 195, the Court should not "assume that Congress, in enacting legislation to prevent fraudulent practices * * *, was unaware of these developments in the common law of fraud."[26] Although the decision in *Hochfelder* clearly delineates the requirements of Section 10(b) in the private damage context, it is essential to recall that "general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used." *Zenith Radio Corp.* v. *United States*, 437 U.S. 443, 462 (1978).[27]

[26] If Congress had intended to depart so substantially from this well established doctrine of equity practice, it would have made its desire plain. See *Rondeau* v. *Mosinee Paper Corp.*, 422 U.S. 49, 61 (1975).

[27] Petitioner argues (Br. 11) that the language of Section 10(b) must have the same implication here as in private

Petitioner's conduct, whether negligent or intentional, is properly viewed as a "deceptive device" under Section 10(b) in this equitable proceeding.[28] The word "deceptive" refers to conduct that might or does mislead other persons. *Webster's New International Dictionary* 578 (1933). There is no question here that the registered representatives under petitioner's supervision engaged in deceptive behavior and that petitioner failed to restrain them despite receiving repeated warnings. Viewed from the perspective of the brokerage firm's customers—a part of the class that Congress meant to protect—petitioner's state of mind had no bearing on the "deceptive"

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damage actions. But as *Capital Gains* establishes, the terminology of fraud traditionally has had two separate and distinct meanings—at law and in equity.

[28] Section 10(b) extends to any "manipulative or deceptive device or contrivance." The words of the statute are expressed in the disjunctive, and each should be given its separate meaning. *Reiter* v. *Sonotone Corp., supra,* slip op. 7; *United States* v. *Naftalin, supra,* slip op. 5. The terms of Section 10(b) that directly apply to petitioner's conduct are "deceptive device." We note, however, that even the word "manipulative" does not always refer to conduct involving scienter, particularly in an injunctive proceeding. For example, a recommendation on the basis of false information may be a form of manipulation in violation of Section 9(a)(4) of the Securities Exchange Act, 15 U.S.C. 78i(a)(4). A broker or other person selling a security registered on a national securities exchange on the basis on such a recommendation may be enjoined from such manipulative activity if he is merely negligent—*i.e.*, if he has "reasonable ground to believe" that his recommendations are untrue. *Ibid.* See *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 209 n.28.

effect of the course of conduct in which he participated.

Moreover, the word "device," although often connoting an intentional scheme to defraud, does not necessarily have such meaning. As this Court explained in *Armour Packing Co.* v. *United States,* 209 U.S. 56, 71 (1908), "[a] device need not be necessarily fraudulent * * *." The Court concluded in *Armour Packing Co.* that the Elkins Act (32 Stat. 847) prohibits all "devices" to obtain rebates or preferences: "Had it been the intention of Congress to limit the obtaining of such preferences to fraudulent schemes or devices, or to those operating only by dishonest, or underhanded methods, it would have been easy to have so provided in words that would be unmistakable in their meaning." Furthermore, Congress used the word "device" in another antifraud provision of the Securities Exchange Act to encompass not just intentional fraud but also negligent acts and practices. See Section 15(c)(1), 15 U.S.C. 78*o*(c)(1); Rule 15c1-2, 17 C.F.R. 240.15c1-2.[29]

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[29] In 1937, only three years after the passage of the Securities Exchange Act, the Commission, by rule, defined the phrase "any manipulative, deceptive, or other fraudulent device or contrivance" appearing in Section 15(c) of the Act (now Section 15(c)(1)) to include "any act, practice, or course of business which operates or would operate as a fraud or deceit" and "any untrue statement of a material fact or omission to state a material fact" where the statement or omission is made with knowledge "or reasonable grounds to believe" that it is untrue or misleading (Rule MC2, Securities Exchange Act Release No. 1330 (Aug. 4, 1937)). In 1938, Congress considered and expressly approved the Commission's

The legislative history of Section 10(b), like the statutory language, does not require an interpretation that would mandate proof of scienter in an injunctive proceeding. The history is virtually silent with respect to the word "deceptive," since that word was not added to the Senate version of Section 10(b) until the final drafts of the bill neared completion. See S. ——, 73d Cong., 2d Sess. § 9(b) (Apr. 14, 1934) (Confidential Committee Print). The word "deceptive" was never included in the House version of Section 10(b). See H.R. 9323, 73d Cong., 2d Sess. (1934); H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 32 (1934).

Similarly, the legislative history of the Securities Exchange Act does not indicate that the word "device" requires proof of scienter in an equitable proceeding. To the contrary, the Senate Committee Report uses the term "device" synonymously with "practice." See S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934), describing the "devices" forbidden by Section 10(b) as "any other manipulative or deceptive practices which [the Commission] finds detrimental to the interests of the investor." See also *id.* at 7; H.R. Rep. No. 1383, 73d Cong., 2d Sess. 10 (1934). Of course, the word "practice" denotes an "action" or "deed" and does not imply intentional wrongdoing. See *Webster's New International Dic-*

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rule when it amended Section 15(c). H.R. Rep. No. 2307, 75th Cong., 3d Sess. 10 (1938); S. Rep. No. 1455, 75th Cong., 3d Sess. 4, 10 (1938); *Regulation of Over-the-Counter Markets: Hearings on S. 3255, H.R. 9634 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 75th Cong., 3d Sess. 13-14, 84-86 (1938).

tionary 1937 (1933). Further, the Senate Report used the word "device" to refer to "the dissemination of false information" (S. Rep. No. 792, 73d Cong., 2d Sess. 8 (1934)), in describing a provision of the bill related to Section 10(b) that would have prohibited misleading statements made to induce the purchase or sale of a listed security without a requirement of culpability. S. 3420, 73d Cong., 2d Sess. § 9(a)(4) (Apr. 20, 1934).

Finally, as this Court observed in *Hochfelder*, the committee reports, in describing the express damage liability sections of the Securities Exchange Act, indicate an intent to relieve a defendant from "damages stemming from 'illicit practices,' where the defendant has * * * acted in good faith." 425 U.S. at 206. There is no indication in the committee reports, however, of any similar intention to relieve a defendant who has engaged in "illicit practices" from the restraint against recurrence of such misconduct provided by an injunction.

In sum, while the language and history of Section 10(b) are supportive of the Court's conclusion that scienter is required in an action for damages—the kind of fraud action in which scienter has traditionally been required by courts of law—they do not support petitioner's different assertion that Congress intended that scienter be proven in an equitable proceeding as a prerequisite to obtaining preventive relief.

3. The Commission's consistent interpretation has been that negligent behavior that deceives investors is a sufficient predicate for injunctive relief under Section 10(b). As noted on page 48 *supra*, the

Commission has succesfuly argued before several courts of appeals that injunctive relief is available under Section 10(b) in such circumstances. That interpretation was accepted by the United .States Court of Appeals for the Second Circuit sitting en banc in *SEC* v. *Texas Gulf Sulphur Co., supra,* which was handed down in 1968. Since that time, the First, Seventh and Tenth Circuits have agreed.

Congress was expressly informed of this administrative interpretation on at least two occasions when significant amendments to the federal securities laws were enacted. On each occasion, Congress left the administrative interpretation undisturbed. In 1975, Congress passed the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97. Those amendments have been described as the "most substantial and significant revision of this country's federal securities laws since the passage of the Securities Exchange Act in 1934." *Securities Acts Amendments of 1975: Hearings on S. 249 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs,* 94th Cong., 1st Sess. 1 (1975). In the process of considering this reform, Congress addressed both the purpose and scope of Commission injunctive remedies. In its report on the bill that ultimately became the Securities Acts Amendments of 1975, the Senate Committee on Housing, Banking and Urban Affairs (which exercises principal oversight responsibility with respect to the Commission) stated:

> [A]lthough both the Commission's suit for injunctive relief brought pursuant to express statutory authority and a private action for damages fall within the general category of civil (as distinct from criminal) proceedings, their objectives are really very different. Private actions for damages seek to adjudicate a private controversy between citizens; the Commission's action for civil injunction is a vital part of the Congressionally mandated scheme of law enforcement in the securities area.
>
> Private actions frequently will involve more parties and more issues than the Commission's enforcement action, thus greatly increasing the need for extensive pretrial discovery. In particular, issues related to * * * scienter, causation, and the extent of damages, are elements *not* required to be demonstrated in a Commission injunctive action.

S. Rep. No. 94-75, 94th Cong., 1st Sess. 76 (1976) (emphasis in original). On the basis of its understanding that proof of scienter and other elements relevant in private damage litigation was *not* required in Commission injunctive proceedings, Congress enacted Section 21(g) of the Act, 15 U.S.C. 78u(g), which provides that, absent consent from the Commission, private actions—raising questions such as the defendant's scienter—may not be consolidated with Commission proceedings.

In 1977, following this Court's decision in *Hochfelder,* Congress enacted the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1495, which amended the Securities Exchange Act of 1934.

Once again, the Commission's interpretation that scienter is not required in injunctive actions was reviewed. See H.R. Rep. No. 95-640, 95th Cong., 1st Sess. 10 (1977) (emphasis omitted):

> Although the Supreme Court has held that private plaintiffs seeking to recover monetary damages for violations of Securities Exchange Act Rule 10b-5 * * * must establish that the defendant acted with scienter, the appellate courts quite properly have never required proof of scienter in any of the Commission's own enforcement proceedings. Compare *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) with *Securities and Exchange Commission* v. *World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976); *Securities and Exchange Commission* v. *Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *Securities and Exchange Commission* v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973). In the context of an SEC action to enjoin future violations of the securities laws, a defendant's state of mind should make no difference. The harm to the public is the same regardless of whether or not the violative conduct involved scienter. Because an SEC enforcement action is designed to protect the public against the recurrence of violative conduct, and not to punish a state of mind, this Committee intends that scienter is not an element of any Commission enforcement proceeding. In so stating, we reaffirm the views expressed in 1975, when the Congress considered the Securities Acts Amendments of 1975. See S. Rep. 94-75, 94th Cong., 1st Sess. (1975) at 76.

Although the Conference Committee stated that consideration of the 1977 amendments was not an appropriate occasion to debate the merits of this Court's *Hochfelder* decision (H.R. Conf. Rep. No. 95-831, 95th Cong., 1st Sess. 11 (1977)), there can be no doubt that the Commission's view concerning a state of mind requirement in injunctive proceedings was clearly brought to the attention of Congress when the 1977 amendments were approved.

This Court has recognized that consistent interpretations of the Commission, which are compatible with the text and purpose of the securities laws, are entitled to deference. See, *e.g.*, *United States* v. *National Association of Securities Dealers, Inc.*, 422 U.S. 694, 718-719 (1975); *E.I. du Pont de Nemours & Co.* v. *Collins*, 432 U.S. 46, 54-55 (1977). That principle takes on added significance when Congress has expressly reviewed the administrative interpretation while amending the securities laws and has left it undisturbed. See, *e.g.*, *Andrus* v. *Allard*, No. 78-740 (Nov. 27, 1979), slip op. 6 ("it is particularly relevant that Congress has twice reviewed and amended the statute without rejecting the Department's view"); *United States* v. *Rutherford*, No. 78-605 (June 18, 1979), slip op. 8-9 & n.10 ("once an agency's statutory construction has been 'fully brought to the attention of the public and the Congress,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned"); *Board of Governors* v. *First Lincolnwood Corp.*, 439 U.S. 234, 248 (1978) ("Congress has been made aware of this [administra-

tive] practice, yet four times has 'revisited the Act and left the practice untouched' "); *Lorillard* v. *Pons*, 434 U.S. 575, 580 (1978) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it reenacts a statute without change"); *Saxbe* v. *Bustos*, 419 U.S. 65, 74 (1974) ("Such a history of administrative construction and congressional acquiescence may add a gloss or qualification to what is on its face unqualified statutory language"); *NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 274-275 (1974); *Red Lion Broadcasting Co.* v. *FCC*, 395 U.S. 367, 381 (1969).

In sum, the consistent administrative interpretation of the statute, construing Section 10(b) to allow injunctive relief without proof of scienter, not only agrees with prior decisions of this Court and the lower federal courts, but also enjoys the presumptive approval of Congress.

4. Finally, interpretation of Section 10(b) and Rule 10b-5 to permit injunctive relief without proof of scienter would harmonize these provisions with Section 17(a), the parallel antifraud provision contained in the Securities Act of 1933. As discussed on pages 35-43, *supra*, Section 17(a) does not impose a scienter requirement in Commission enforcement actions. However, Section 17(a) only extends to deceptive or misleading practices in the offer or sale of securities. If Section 10(b) were construed to impose a scienter requirement in injunctive actions, the protection afforded to public investors would be haphazard and fortuitous, depending on whether the deceived investor was a "buyer" or a "seller" of securities. Under such a construction, frauds practiced on sellers would be subject to equitable restraint under Section 10(b) only if the Commission could prove scienter, whereas frauds practiced on buyers could be restrained under Section 17(a) based on a showing of negligence.

This illogical construction would run counter to the underlying congressional purpose in enacting the securities laws—to provide fair and effective protection for all investors against deceptive practices. See, *e.g.*, 77 Cong. Rec. 2918 (1933) (remarks of Rep. Rayburn) ("The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller"). See also Section 2 of the Securities Exchange Act, 15 U.S.C. 78b. Such an interpretation "would create a loophole in the statute that Congress simply did not intend to create." *United States* v. *Naftalin*, *supra*, slip op. 8.[30]

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[30] An interpretation of Section 10(b) and Rule 10b-5 that permits injunctive relief on the basis of negligence would also harmonize the treatment of listed and unlisted securities. If scienter is required under Section 10(b), Section 9(a)(4) will nevertheless prohibit misrepresentations, not involving scienter, made to induce transactions in securities listed on a national securities exchange. See note 28, *supra*. No comparable prohibition would apply to unlisted securities. The availability of injunctive relief, however, should not depend on whether the securities involved are listed.

The words of the Securities Exchange Act should not be construed in a manner that conflicts with the "purpose" and "spirit" of the legislation. See *United Housing Foundation, Inc.* v. *Forman, supra,* 421 U.S. at 849, citing *United States* v. *American Trucking Ass'ns, Inc., supra,* 310 U.S. at 543 (statutory terms should not be interpreted to produce an "unreasonable" result " 'plainly at variance with the policy of the legislation as a whole' "). Indeed, construing Section 10(b) in a way that is consistent with its remedial purpose and that would harmonize its operation with Section 17(a) would be in accord with the principle of statutory interpretation frequently applied by the Court under Section 10(b). See *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151 (1972) .("Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes' "); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6, 12 (1971); *SEC* v. *National Securities, Inc., supra,* 393 U.S. at 467; *Tcherepnin* v. *Knight,* 389 U.S. 332, 336 (1967). Permitting the Commission to obtain injunctive relief under Section 10(b) to avoid deceptive practices in securities transactions without proof of scienter plainly would facilitate the statute's remedial purpose.

IV. The Structure Of The Securities Act Of 1933 And The Securities Exchange Act Of 1934 Confirms That The Commission Need Not Prove Scienter In An Injunctive Proceeding

As discussed above, the history and text of Sections 17(a) and 10(b) establish that they do not require scienter in an injunctive proceeding brought by the Commission to restrain deceptive practices. This interpretation is reinforced by the traditional meaning of securities fraud in equity, as summarized by the Court in *SEC* v. *Capital Gains Research Bureau, Inc., supra.* As we demonstrate below, the conclusion that scienter is not required in the present context becomes even more apparent when the language Congress used to prescribe state of mind standards throughout the securities laws is compared to the language employed in Sections 17(a) and 10(b), as well as in Sections 20(b) and 21(d), the statutory provisions authorizing injunctive relief.

The words repeatedly used by Congress in the Securities Act and the Securities Exchange Act, as well as in subsequent federal securities legislation, to denote state of mind standards are forms of the words "knowing,"[31] "willful,"[32] and "good

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[31] See Sections 10(a)(3), 11(a), 11(b)(2), 11(e), 12(2) and 15 of the Securities Act, 15 U.S.C. 77j(a)(3), 77k(a), 77k(b)(2), 77k(e), 77*l*(2) and 77*o*; Sections 9(a)(1)(C), 9(a)(4), 18(a), 29(b), 29(c) and 32(a) of the Securities Exchange Act, 15 U.S.C. 78i(a)(1)(C), 78i(a)(4), 78r(a), 78cc(b) and 78cc(c) and 15 U.S.C. (Supp. I) 78ff(a). When Congress amended the Securities Exchange Act in 1964, 1975 and 1977, it continued to use this language. See Sections 3(a)(39)(D), 6(c)(2), 15(b)(6), 15A(g)(2), 15B(c)(4),

17A(b)(4)(A) and 30A(a)(3) of the Securities Exchange Act, 15 U.S.C. 78c(a)(39)(D), 78f(c)(2), 78*o*(b)(6), 78*o*-3(g)(2), 78*o*-4(c)(4) and 78q-1(b)(4)(A) and 15 U.S.C. (Supp. I) 78dd-1(a)(3). Similarly, Congress used this language in Sections 26(b), 26(c) and 29 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z(b), 79z(c) and 79z-3; Sections 310(b)(7), 310(b)(8), 313(a)(1) and 323(a) of the Trust Indenture Act of 1939, 15 U.S.C. 77jjj(b)(7), 77jjj(b)(8), 78mmm(a)(1) and 77www(a); Sections 10(f), 12(d)(1)(B), 17(a)(1), 17(a)(2), 20(d), 47(b) and 49 of the Investment Company Act of 1940, 15 U.S.C. 80a-10(f), 80a-12(d)(1)(B), 80a-17(a)(1), 80a-17(a)(2), 80a-20(d), 80a-46(b) and 80a-48; and Sections 203(f), 206(3) and 215(b) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3(f), 80b-6(3) and 80b-15(b).

[32] See Section 24 of the Securities Act, 15 U.S.C. 77x; Sections 9(e) and 32(a) of the Securities Exchange Act, 15 U.S.C. 78i(e) and 78ff(a). When Congress amended the Securities Exchange Act in 1936 to provide administrative remedies, it specified when proof of willful misconduct was required. See Section 15(b)(4)(A), (D) and (E) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4)(A), (D) and (E). Congress continued this pattern in subsequent years when it further amended the Securities Exchange Act. See Sections 3(a)(39)(E), 15B(c)(4), 17A(c)(3)(A), 19(h)(2), 19(h)(3), 19(h)(4), 32(c)(2) and 32(c)(3), 15 U.S.C. 78c(a)(39)(E), 78*o*-4(c)(4), 78q-1(c)(3)(A), 78s(h)(2), 78s(h)(3) and 78s(h)(4) and 15 U.S.C. (Supp. I) 78ff(c)(2) and 78ff(c)(3). In other securities statutes Congress frequently used the word "willful" to denote a state of mind requirement. See Section 29 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z-3; Section 325 of the Trust Indenture Act, 15 U.S.C. 77yyy; Sections 9(b)(1), 9(b)(2), 9(b)(3), 17(h), 17(i), 34(a), 37 and 49 of the Investment Company Act of 1940, 15 U.S.C. 80a-9(b)(1), 80a-9(b)(2), 80a-9(b)(3), 80a-17(h), 80a-17(i), 80a-33(a), 80a-36 and 80a-48; Sections 203(e)(1), 203(f), 207 and 217 of the Investment Advisers Act, 15 U.S.C. 80b-3(e)(1), 80b-3(f), 80b-7 and 80b-17.

faith."[33] The concept of state of mind is treated with precision, and the omission of such language in Sections 17(a), 10(b), 20(b) and 21(d) therefore cannot be attributed to oversight. If Congress had intended to depart from the traditional doctrine of fraud in equity—a departure that should not lightly be presumed (see *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 192-195)—it would have said so expressly. See *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, *supra*, slip op. 8-10; *Blue Chip Stamps* v. *Manor Drug Stores*, *supra*, 421 U.S. at 734. As the Court observed in *Hecht Co.* v. *Bowles*, 321 U.S. 321, 329 (1944), "if Congress had intended to make such a drastic departure from the traditions of equity practice, an unequivocal statement of its purpose would have been made."

A comparison of Sections 20(b) and 21(d), which empower the district courts to enjoin unlawful practices in securities transactions, with provisions authorizing other governmental remedies highlights

[33] See Section 19(a) of the Securities Act, 15 U.S.C. 77s(a); Sections 16(b), 16(c), 18(a), 20(a), 23(a)(1), 28(e)(1) and 29(c) of the Securities Exchange Act, 15 U.S.C. 78p(b), 78p(c), 78r(a), 78t(a), 78w(a)(1), 78bb(e)(1) and 78cc(c). See also Sections 3(c), 17(b), 20(d) and 26(c) of the Public Utility Holding Company Act, 15 U.S.C. 79c(c), 79q(b), 79t(d) and 79z(c); Sections 315(d)(2), 315(d)(3), 319(c) and 323(a) of the Trust Indenture Act, 15 U.S.C. 77*ooo*(d)(2), 77*ooo*(d)(3), 77sss(c) and 77www(a); Sections 3(b)(2), 12(f) and 38(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-3(b)(2), 80a-12(f) and 80a-37(c); and Section 211(d) of the Investment Advisers Act, 15 U.S.C. 80b-11(d).

the significance of the absence of state of mind language in the injunction provisions. In sharp contrast to certain statutory provisions authorizing administrative sanctions against persons who "willfully" violate the securities laws,[34] and unlike the provisions authorizing criminal prosecutions of persons who "willfully" commit securities violations,[35] Sections 20(b) and 21(d) require a "proper showing" for an injunction to issue. Although a district court, in determining whether a proper showing has been made, may consider scienter as one of several aggravating or mitigating factors in exercising its equitable discretion to grant injunctive relief (see, *e.g.*, *SEC* v. *Universal Major Industries Corp.*, 546 F.2d 1044, 1048 (2d Cir. 1976), cert. denied, 434 U.S. 834 (1977)), the statute does not

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[34] See Section 15(b)(4)(A), (D) and (E) and Section 15B(c)(4) of the Securities Exchange Act, 15 U.S.C. 78*o* (b)(4)(A), (D) and (E), and 78*o*-4(c)(4). See also Section 9(b) of the Investment Company Act, 15 U.S.C. 80a-9(b); Section 203(e)(1), (4), (5) of the Investment Advisers Act, 15 U.S.C. 80b-3(e)(1), (4), (5).

[35] See Section 24 of the Securities Act, 15 U.S.C. 77x; Section 32(a) of the Securities Exchange Act, 15 U.S.C. (Supp. I) 78ff(a). See also Section 29 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z-3; Section 325 of the Trust Indenture Act of 1939, 15 U.S.C. 77yyy; Section 49 of the Investment Company Act of 1940, 15 U.S.C. 80a-48; Section 217 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-17.

impose a scienter or other state of mind requirement.[36]

The statutory design summarized above manifests a clear congressional purpose to eliminate securities fraud. Congress has prescribed a variety of remedies to protect the public against deceptive practices in securities transactions. Yet under petitioner's proposed interpretation of the Securities Act and the Securities Exchange Act, the Commission could not obtain the mild prophylactic remedy of injunctive relief without proof of a state of mind that would justify imposition of a severe prison sentence. A district court that finds both that a defendant has engaged in deceptive securities practices and that he is likely to continue to do so unless restrained would be powerless to protect the public against serious financial losses without proof of intent to deceive. The structure of the Acts confirms that Congress did not intend such an illogical result.[37]

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[36] Moreover, in two provisions regulating conduct similar to that covered by Sections 17(a) and 10(b), Congress prescribed that proof of state of mind was a prerequisite to obtaining money damages, but not to obtaining injunctive relief. Compare Section 9(e) of the Securities Exchange Act, 15 U.S.C. 78i(e), with Section 9(a)(4) of the Securities Exchange Act, 15 U.S.C. 78i(a)(4). See *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 209 n.28; note 28, *supra*.

[37] Amicus AICPA argues (Amicus Br. 16) that the court of appeals erred in stating that the same pattern of culpability requirements fashioned by Congress in the Securities Act of 1933 was incorporated in the Securities Exchange Act of 1934, noting that the section relied on by the court of appeals

V. Imposition Of A Scienter Standard In Commission Injunctive Proceedings Would Undermine The Intention Of Congress To Eliminate Deception In Securities Transactions

As a final step in statutory interpretation, it is appropriate to consider the practical consequences of the competing interpretations that are proposed and their consistency with the overall purposes of the legislation.[38] Petitioner agrees, contending that the Court should give consideration to the adverse effects of injunctions on persons restrained from engaging in deceptive behavior (Br. 14 n.12). This line of

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(Section 210 of Title II of the 1934 Act, 48 Stat. 905) "merely transfers the administration of the 1933 Act from the Federal Trade Commission to the Securities and Exchange Commission." As officially reported, however, the court of appeals' opinion omits reference to Section 210 and states (605 F.2d at 622 n.14):

> By incorporating in the 1934 Act the same pattern of culpability requirements established by the 1933 Act, namely, by requiring willfulness both in criminal prosecutions under the Act * * * and in suspending or revoking the registration of a broker or dealer * * *, Congress clearly indicated its rejection of a scienter standard for injunctive relief * * * in that [the section authorizing such injunctive relief under the 1934 Act] has no requirement of willfulness.

[38] Consistent with the purposes discussed below, the proposed Federal Securities Code—approved by both the American Law Institute (Supplement to Proposed Official Draft, July 15, 1978) and the American Bar Association (65 A.B.A.J. 295, 341 (1979))—provides that the Commission, unlike private parties seeking damages, will be able to obtain an injunction to prevent deception and misrepresentation without proof of scienter. See Sections 262(d), 297(a), 1602(a), 1819(a)(3), and 1819(a)(4) (Proposed Official Draft, Mar. 15, 1978).

argument, however, completely ignores the vital role that Commission injunctive proceedings play in preventing the serious harm to investors and the economy that can flow from false and misleading financial information.

1. As noted above, Sections 17(a) and 10(b) are the primary antifraud provisions of the Securities Act and the Securities Exchange Act; they are the principal statutory provisions through which the Commission, in injunctive proceedings, seeks to protect the public against deception in securities transactions. If deception stemming from carelessness is not prohibited by these statutory provisions, the economic interests of participants in the securities markets would be seriously impaired. Financial information disseminated in the national securities markets is used by individual investors, as well as by institutional investors such as bank trust departments, insurance companies, mutual funds, pension funds, arbitrageurs, securities dealers, and corporations engaged in tender offers. As this Court has observed, "the welfare of investors and financial intermediaries are inextricably linked—frauds perpetrated upon either business or investors can redound to the detriment of the other and to the economy as a whole." *United States* v. *Naftalin*, *supra*, slip op. 7. The general public depends heavily on financial information disseminated by persons such as securities brokers, corporations issuing financial data, and accountants certifying financial statements, in making investment decisions of substantial importance, whether it be the investment of the life savings of an

individual or a tender offer for securities by a corporate bidder.

"In our complex society," Judge Friendly has remarked, false and misleading representations about financial matters "can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." *United States* v. *Benjamin*, 328 F.2d 854, 863 (2d Cir.), cert. denied, 377 U.S. 953 (1964). Under modern tort doctrine, persons who make material representations in connection with financial transactions are required to exercise reasonable care to avoid deceiving other persons whose economic interests depend on the truthfulness of such representations. See, *e.g.*, *Restatement (Second) of Torts* Section 552 (1977). Likewise, if, through carelessness, false information is conveyed, and the resulting deception threatens to be recurrent and injurious, the district courts should not be powerless to protect the public through the prophylactic remedy of an injunction under the securities laws. An injunction in such circumstances does not, of course, rest on blameless conduct. To the contrary, that injunction is directed to a defendant whose conduct has fallen below the standard of care that reasonable men would exercise in the circumstances and which threatens to cause continuing injury to the investing public.

The reported cases clearly illustrate the essential role of injunctions in protecting the public against negligent dissemination of false information in connection with securities transactions. See, *e.g.*, *SEC* v. *World Radio Mission, Inc.*, *supra*, 544 F.2d at 539-

541 (negligent failure to disclose issuer corporation's financial deficit and minimal earnings power during securities offering); *SEC* v. *Manor Nursing Centers, Inc.*, *supra*, 458 F.2d at 1095-1097 (negligent failure to correct false prospectus after defendants received notice of material errors); *SEC* v. *Management Dynamics, Inc.*, *supra*, 515 F.2d at 803-805, 809 (negligent misstatements in press release and letter disseminated to the investing public); *SEC* v. *American Realty Trust Co.*, 586 F.2d 1001, 1004-1007 (4th Cir. 1978) (negligent misstatements in prospectus and proxy statement filed with the Commission and disseminated to investors); *SEC* v. *Van Horn*, 371 F.2d 181, 184 (7th Cir. 1966) (negligent misrepresentations concerning the financial condition of the issuer company during offer and sale of securities). In each case, the negligence of the defendants had the clear potential to mislead investors and cause serious financial losses. And in each case, the injunction imposed by the court protected the public by requiring the defendants to cease engaging in deceptive practices.

2. To foreclose injunctive relief where deception has resulted from failure to exercise due care would be contrary to Congress' purposes in enacting the federal securities laws. The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted in "the aftermath of the market crash in 1929." *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 194. The two statutes are "interrelated components of the federal regulatory scheme governing transactions in securities" (*id.* at 206), a scheme of federal super-

vision intended to "bring back public confidence" in the national securities markets by "add[ing] to the ancient rule of *caveat emptor*, the further doctrine 'let the seller also beware.'" President's Message to Congress (Mar. 29, 1933), reproduced in S. Rep. No. 47, 73d Cong., 1st Sess. 6-7 (1933) and H.R. Rep. No. 85, 73d Cong., 1st Sess. 1-2 (1933).

In the view of Congress, the dissemination of false and misleading information to the investing public had triggered a crisis in confidence in the securities markets and had contributed to the breakdown in the national economy (H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933)):

> The background of the President's message is only too familiar to everyone. During the post-war decade some 50 billions of new securities were floated in the United States. Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises.

The House Report added that "[e]qually significant with these countless individual tragedies is the wastage that this irresponsible selling of securities has caused to industry." *Ibid.* The Senate Report that preceded passage of the Securities Act tells a similar story (S. Rep. No. 47, 73d Cong., 1st Sess. 2 (1933)):

> The necessity for the bill arises out of the fact that billions of dollars have been invested in practically worthless securities, both foreign and domestic, including those of foreign governments, by the American public through incomplete, careless, or false representations. The result is dire national distress. * * * [T]he losses of investors have been appalling. Those who have considered the matter place such losses in this country at $1,700,000,000 annually * * *.

See also 77 Cong. Rec. 2919, 2950-2951, 2983 (1933); Stock Exchange Regulation, Report to the Secretary of Commerce, 73d Cong., 2d Sess. 3, 19 (1934). Congress' concern about the effect on the public and the economy of negligent dissemination of false information appears throughout the legislative history. See, e.g., S. Rep. No. 47, 73d Cong., 1st Sess. 2 (1933); H.R. Rep. No. 85, 73d Cong., 1st Sess. 2, 3, 5, 9, 22-23 (1933); H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933); H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 27-29, 32 (1934). As this Court has noted, the securities legislation that resulted from these concerns was intended to impose on securities

profesionals a " 'high standard of business ethics * * *.' " *United States* v. *Naftalin, supra*, slip op. 6; *SEC* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. at 186-187.

An interpretation of the securities laws permitting the Commission to restrain deceptive practices resulting from negligence is essential in curtailing the abuses that Congress meant to eliminate.[39]

3. Petitioner and amicus AICPA nonetheless argue (Pet. Br. 13-14; Amicus Br. 22-27) that the burdens and collateral consequences flowing from an injunction are often substantial and militate against allowing the Commission to obtain injunctive relief in a case such as this.[40] It is undeniable that persons

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[39] Although amicus AICPA suggests (Amicus Br. 23) that an inference of scienter might be drawn from persistence in a course of negligent conduct, the fact that scienter may be established in this way in some cases does not minimize the importance of injunctive relief in other negligence cases. The public is entitled to protection when continued negligent deception is a reasonable prospect, even though the defendant's conduct does not fairly support an inference that he acted with scienter or will in the future act with scienter.

[40] This argument derives no support whatsoever from the governing statutes. Nothing in the language of the injunctive and antifraud provisions links the propriety of granting injunctive relief to the possible collateral consequences that might follow. The administrative disciplinary sanctions under the securities laws to which petitioner refers were not part of the Securities Act or the Securities Exchange Act at the time that the injunctive and antifraud provisions were enacted in 1933 and 1934. Moreover, the collateral consequences to which petitioner refers apply only to a limited category of persons. Thus, they cannot logically be relied on to

enjoined for deceiving others may sometimes suffer inconvenience and disability as a result of a judicial restraining order. But these considerations are hardly a justification for permitting those engaged in deception to continue their conduct. Those who depart from professional standards by deceiving others and who threaten to continue to do so are properly subject to an injunctive order: "[T]he propriety of an injunction depends largely on the relative culpability of the violation. The weapon is best suited for application to negligent malfeasors whose future compliance may be stimulated by a judicial mandate * * *." Note, *The Statutory Injunction As An Enforcement Weapon of Federal Agencies*, 57 Yale L.J. 1023, 1046-1047 (1948).

Indeed, the argument of amicus AICPA that negligent conduct, resulting in the deception of investors, should not be subject to a corrective order to protect the public is difficult to square with its own statements in 2 AICPA Professional Standards (CCH), Sections 50.01-50.02: "A distinguishing mark of a professional is his acceptance of responsibility to the public * * *. The reliance of the public, the government and the business community on sound financial reporting and advice on business affairs, and the importance of these matters to the economic and social aspects of life impose particular obliga-

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require proof of scienter in proceedings brought to enjoin future violations of antifraud provisions that apply to "any person."

tions on certified public accountants." Negligence by professionals such as brokers and accountants may expose them to legal consequences far more serious than injunctive relief. Negligent mispresentations may result in common law tort claims for money damages. Compare *Restatement (Second) of Torts*, *supra*, Section 552 (scienter not required when information is supplied by a professional for the guidance of others in business transactions) with Sections 525 and 526 (scienter is generally required in a tort action for fraudulent misrepresentation); see *Rhode Island Hospital Trust Nat. Bank* v. *Swartz*, 455 F.2d 847 (4th Cir. 1972). Misrepresentations that are negligent can also lead to liability in money damages under the federal securities laws. See, *e.g.*, Sections 11 and 12(2) of the Securities Act of 1933, 15 U.S.C. 77k, 77*l*(2). See also *Wilko* v. *Swan*, 346 U.S. 427, 430-431 (1953).

Moreover, the arguments of petitioner and amicus about the unfairness of injunctive relief ignore the equitable discretion of the district court to arrive at an "adjustment and reconciliation between the public interest and private needs * * *." *Hecht Co.* v. *Bowles*, *supra*, 321 U.S. at 329. The courts have discretion to refuse to issue an injunction that is not required under all the circumstances. For example, even though scienter is not an essential element of a statutory violation, a court may still consider that factor, as well as others, in determining whether to

issue an injunction. See pages 64-65, *supra*. The court may properly take into account

> the likelihood of future violations, the degree of scienter involved, the sincerity of defendant's assurances against future violations, the isolated or recurrent nature of the infraction, defendant's recognition of the wrongful nature of his conduct, and the likelihood, because of defendant's professional occupation, that future violations might occur.

SEC v. *Universal Major Industries Corp.*, *supra*, 546 F.2d at 1048. The inherent power of the district courts to "do equity" in particular cases provides substantial assurance against unfairness in decreeing injunctive relief.

4. Although petitioner argues (Br. 13-14) that the Commission should be denied authority to seek injunctive remedies against negligent deceptive practices because of collateral administrative sanctions flowing from an injunction, he fails to recognize that such collateral sanctions are separate from the injunctive remedy and are essentially discretionary in nature.

Certain categories of persons enjoined from engaging in securities fraud are subject to administrative sanctions if their conduct is such that the public interest requires additional protection. These persons are subject to special regulatory scrutiny because of the substantial sensitivity of their positions and the grave consequences to the public of their defaults. For example, a broker's registration may be suspended or revoked if he is subject to an injunction; a professional's privilege to practice before the Com-

mission may be suspended; and an issuer of securities is barred from utilizing certain exemptions from the registration requirements of the Securities Act.

But these collateral consequences are essentially discretionary. Under Section 15(b)(4) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4), for example, administrative sanctions against a broker may only be invoked after notice and a hearing and only if the Commission finds that such action is in the public interest. Similarly, under Rule 2(e)(3) of the Commission's Rules of Practice, 17 C.F.R. 201.2(e)(3), suspension of the right to practice before the Commission is only ordered when consistent with the "public interest," and the respondent may "show cause" why suspension is unnecessary. See also Section 203(e) of the Investment Advisers Act, 15 U.S.C. 80b-3(e). Section 9(c) of the Investment Company Act, 15 U.S.C. 80a-9(c), authorizes the Commission to modify sanctions that are imposed by that Act where they are unduly severe or not in the public interest. See also Rule 252(f) under the Securities Act, 17 C.F.R. 230.252(f). The subject of administrative sanctions has the right to show why the sanctions are unnecessary or inappropriate and to seek judicial review. See, *e.g.*, *Shuck* v. *SEC*, 264 F.2d 358, 362 (D.C. Cir. 1958) (when the Commission imposes sanctions on the basis of an injunction, "its action must be fair and just under all the circumstances, and lacking in any element of an arbitrary or capricious nature, as well as being in the public interest").

5. The Commission is the agency charged with administering the federal securities laws in the public interest. "A vigorous and effective enforcement program is critical to the Commission's ability to carry out its responsibility to protect investors." 1978 *Annual Report of the Securities and Exchange Commission* vi. The injunctive proceeding, as this Court noted in *Hochfelder*, is one of the important remedies in the "arsenal of flexible enforcement powers" granted to the Commission by Congress—powers vested in the Commission in recognition of the inadequacy of a "rigid statutory program" and the need for enforcement tools in addition to the "numerous carefully drawn express civil remedies and criminal penalties" in the federal securities laws. 425 U.S. at 195. Indeed, the injunction is the "basic tool provided the Commission for requiring compliance" with the securities laws.[41] Through an injunctive proceeding, the Commission, acting as a statutory guardian of the public interest,[42] brings "to the defendants' attention their past infraction[s] * * * and [lays] down a specific admonitory prescription to guide their future course." *United States* v. *Custer Channel*

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[41] *SEC* v. *IMC International, Inc.*, 384 F.Supp. 889, 894 (N.D. Tex.), aff'd without opinion, 505 F.2d 733 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975).

[42] The Commission sues not as an ordinary litigant but rather "as a statutory guardian charged with safeguarding the public interest * * * and 'the standards of the public interest, not the requirements of private litigation, measure the propriety and need for injunctive relief.'" *SEC* v. *Management Dynamics, Inc., supra*, 515 F.2d at 808, quoting *Hecht Co.* v. *Bowles, supra*, 321 U.S. at 331.

Wing Corp., 376 F.2d 675, 682 (4th Cir.), cert. denied, 389 U.S. 850 (1967).[43]

No consideration of fairness is violated by requiring persons who have engaged in deceptive conduct to be "more than normally careful in their behavior not to repeat the offense." *United States* v. *Custer Channel Wing Corp.*, *supra*, 376 F.2d at 682. When compared either to the damage inflicted on the public and the national economy by such deceptive conduct in securities transactions or to the effect of private damage remedies on a defendant who engages in deceptive behavior, the injunction is indeed a "mild prophylactic." *SEC v. Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 193.

Petitioner's contrary view, if accepted, would ultimately result in injury not only to investors but also

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[43] This Court has often noted the importance of preserving the flexibility and effectiveness of the government's injunctive remedies—"[where] the public interest is involved," the equitable powers of the district court "assume an even broader and more flexible character." *Porter* v. *Warner Holding Co.*, 328 U.S. 395, 398 (1946). See also *Hecht Co.* v. *Bowles*, *supra*, 321 U.S. at 329. "Courts of equity may, and frequently do, go much farther both to give and withhold relief in furtherance of the public interest than they are accustomed to go when only private interests are involved." *United States* v. *First National City Bank*, 379 U.S. 378, 383 (1965).

The Court's recent decisions restricting the availability of private "implied" remedies underscore the importance of regulating deceptive practices in the securities markets through governmental enforcement proceedings. In the absence of effective government enforcement of these statutes, the abuses that Congress determined to be causes of the stock market crash of 1929 will not be effectively restrained.

to the securities industry itself by undermining investor confidence in securities professionals and by providing a competitive advantage to those persons disposed to ignore professional standards in making securities recommendations. In these circumstances, the court of appeals was entirely correct in concluding that "the increased effectiveness of government enforcement actions predicated on a showing of negligence * * * outweigh[s] the danger of potential harm to those enjoined from violating the securities laws" (Pet. App. 15a).

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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